

REPORT BY THE
AUDITOR GENERAL
OF CALIFORNIA

**THE STATE CAN INCREASE TAX ASSESSMENTS
BY IDENTIFYING PERSONS WHO EARN
COMMISSIONS BUT FAIL TO FILE TAX RETURNS**

REPORT BY THE
OFFICE OF THE AUDITOR GENERAL
TO THE
JOINT LEGISLATIVE AUDIT COMMITTEE

P-370

THE STATE CAN INCREASE
TAX ASSESSMENTS BY IDENTIFYING
PERSONS WHO EARN COMMISSIONS
BUT FAIL TO FILE TAX RETURNS

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August 15, 1984

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Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning the need for the Franchise Tax Board to expand its audit activities to identify persons who receive commissions and do not file tax returns.

Respectfully submitted,

Thomas W. Hayes
THOMAS W. HAYES
Auditor General

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SUMMARY

The Franchise Tax Board (board) can assess additional state income taxes by expanding its identification of persons who receive commissions but do not file tax returns. We estimate that the additional tax assessments could have totaled \$2.9 million for tax year 1982 alone. Commissions are paid to persons, such as real estate agents, truck drivers, and insurance brokers, who perform services on behalf of others.

During 1983, organizations that distribute taxable income provided the board with forms reporting payments of interest, dividends, and commissions for tax year 1982. Approximately 83,000 of these forms indicated commissions of at least \$10,000, the minimum gross income for which state law generally requires filing a tax return. The board relied on the Internal Revenue Service (IRS), which also receives reports of commission income, to transcribe onto magnetic tape the data on commissions. The board used the data in a computer search to identify persons who receive commissions but who do not file state tax returns. However, because the IRS transcribed information from only 52 percent of the forms indicating payments of commissions in 1982, the board did not identify all persons who received commissions but did not file state tax returns.

Based on our examination of a sample of 1,000 of the 83,000 forms indicating commissions of at least \$10,000 in 1982, we estimate that the board could have assessed income taxes on 1,500 persons who failed to file tax returns on commissions. We further estimate that these persons may owe the State \$2.9 million in taxes and penalties. By identifying all persons who failed to file tax returns reporting commissions of at least \$10,000, the board could have provided a net fiscal benefit to the State of at least \$2.6 million and up to \$2.8 million, depending on staff costs and staff assignments.

Recommendations

The Franchise Tax Board should transcribe data from all forms indicating commissions of at least \$10,000. Using this information in conjunction with data supplied on magnetic tape by the Internal Revenue Service, the board should identify all persons who should file state tax returns on commissions and should assess taxes on persons who have not filed the required returns.

INTRODUCTION

The Franchise Tax Board (board) is responsible for collecting California taxes under the Bank and Corporation Tax law and the Personal Income Tax law. To administer these laws, the board was authorized \$89.6 million during fiscal year 1983-84. As part of its responsibility, the board operates the Filing Enforcement Program, which identifies individuals and businesses that should have filed tax returns.

State law requires individuals to file tax returns depending upon the amount of income they received during a year. For example, the law requires single persons to file tax returns if they received at least \$10,000 in gross income during one year; married persons must file if their gross income was at least \$12,000. The board's Filing Enforcement Program uses computers to compare information from tax returns with information from other sources to determine if persons with these income levels have filed tax returns as required.

To compare information from tax returns with information from other sources, the board transcribes onto magnetic tape information from tax returns. This information is then entered into a computer to create a "taxpayer's record" for each taxpayer; each taxpayer's record includes data about the taxpayer's income earned and taxes paid. The Internal Revenue Service (IRS) also transcribes information from federal tax returns to create federal taxpayer's records.

In addition to information on tax returns, the board and the IRS receive information from organizations that distribute taxable income. For example, financial institutions must report interest paid to depositors, and businesses must report dividends paid to stockholders. Furthermore, businesses must report as "commissions" payments to persons who represent the businesses. Commissions are paid to real estate agents, truck drivers, insurance brokers, and persons in similar occupations.

To report the distribution of taxable income, organizations may use either magnetic tape, which is readily usable by computers, or forms called "information returns." For example, the Employment Development Department uses magnetic tape to report wages that businesses pay employees. Other organizations, however, submit much of the income information on information returns. One information return that organizations submit to the IRS on income taxable under federal law is "Form 1099." One information return submitted to the board on income taxable under state law is "Form 599." Financial institutions and businesses can submit to the board Form 1099 instead of Form 599 if the taxable income reported to the State for a specific person is the same amount reported to the federal government for that person.

During tax year 1982, organizations that paid commissions reported those payments to the IRS on Form 1099NEC. Organizations reported commissions to the board on Form 599, indicating on the form that the amounts reported were commissions. We refer to Form 1099NEC

and the Form 599 that indicated commissions as "commission income reports." We estimate that the board received approximately 463,000 commission income reports for tax year 1982 and that approximately 83,000 of these reports indicated commissions of at least \$10,000.

To use data from the information returns in computers, the IRS and the board must transcribe the data onto magnetic tape. Once the data are entered into computers, the IRS and the board can verify the existence and accuracy of taxpayer's records. At the present time, the board has contracts with the IRS that enable the board to receive information from the federal taxpayer's records. This information also includes data that the IRS received and transcribed from federal information returns, including Form 1099NEC.

The board uses a computer to match data from tax returns and data from information returns to identify cases in which persons received taxable income but did not file tax returns. The number of cases the board has identified from this comparison has increased from 97,000 in 1973 to 358,000 in 1983.

The board audits these cases further to determine if the persons identified by the computer match are required to file tax returns. In many instances, the board determines that a person either did file a tax return on the taxable income or was not required to file a return. When the board confirms that a person did not file a required tax return, the board may assess the person any income taxes and penalties owed.

SCOPE AND METHODOLOGY

We reviewed the Franchise Tax Board's use of information on taxable income to assess additional income taxes. We concentrated our review on the Filing Enforcement Program and the board's use of data from organizations and the Internal Revenue Service to identify persons who receive commissions but do not file tax returns. Our review covers the board's use of information for tax year 1982.

To obtain information about the board's use of data received under the contract with the Internal Revenue Service, we interviewed Franchise Tax Board officials responsible for the Filing Enforcement Program and Internal Revenue Service officials who transcribe data from federal tax returns and information returns.

To review the board's use of information returns in identifying persons who have not filed tax returns for tax year 1982, we examined a sample of 1,000 of the estimated 83,000 commission income reports that indicate commissions of at least \$10,000. We compared data from those reports with data from tax returns to determine if the persons who received commissions had filed tax returns for 1982. In instances where we could not readily determine if the persons had filed returns, we worked with staff members of the board to confirm that the persons were required to file tax returns and may owe additional taxes.

We calculated the additional taxes and penalties owed using a method similar to the method that the board employs in the Filing Enforcement Program. Because a portion of the commission income reports had been destroyed prior to our review, we were unable to take our sample from all reports for tax year 1982. Consequently, our figures are estimates instead of statistical projections.

We also calculated the cost to the board of transcribing all 83,000 commission income reports and auditing cases in which persons with taxable income did not file tax returns. We based our calculations of this cost on the Employment Development Department's experience with sorting Form 599, the board's experience with transcribing Form 599, and the board's experience with auditing other cases in the Filing Enforcement Program.

AUDIT RESULTS

THE FRANCHISE TAX BOARD DOES
NOT IDENTIFY ALL PERSONS WHO
RECEIVE COMMISSIONS BUT FAIL
TO FILE INCOME TAX RETURNS

The Franchise Tax Board (board) does not use all data on taxable income to identify persons who fail to file required tax returns on commissions. If the board had used all data submitted for tax year 1982, we estimate that it could have assessed an additional \$2.9 million in income taxes and penalties on 1,500 persons who did not file tax returns on commissions earned in that year. If the board had used existing staff members to identify these persons, the net fiscal benefit to the State would have been at least \$2.6 million; if the board had hired additional staff for this assignment, the net benefit would have been as much as \$2.8 million.

The Board Did Not Use
All Information Returns
When Reviewing Tax Returns

To identify persons who should have filed tax returns, the board uses computers to match data on tax returns and data on information returns submitted by organizations that distribute taxable income. The board relies on the Internal Revenue Service (IRS) to transcribe onto magnetic tape data from information returns submitted by organizations that distributed taxable income in California. However, because the IRS did not transcribe data from all information

returns reporting commissions (commission income reports) for tax year 1982, the board could not use data from all of the commission income reports in its computer match.

According to the coordinator of the Information Return Program at the Fresno Service Center of the IRS, the IRS transcribed data from 52 percent of the federal commission income reports--Form 1099NEC--that reported payments of commissions in California during 1982. The board did not transcribe data from the state commission income reports--Form 599 reporting commissions--because it was relying on the IRS to transcribe the data. In addition, because the IRS plans to transcribe data from all information returns in the future, the board does not want to duplicate federal activity.

The Board Did Not Identify
All Individuals Who Should
Have Filed Tax Returns

Because the board did not transcribe the data from all state information returns onto magnetic tape, it did not identify all persons who received commissions but did not file tax returns. Approximately 83,000 commission income reports submitted to the board for tax year 1982 indicated commissions of at least \$10,000. We compared data from 1,000 of the 83,000 commission income reports with taxpayer records and found 72 cases in which persons who received at least \$10,000 in commissions did not file state income tax returns.

The board was aware of 54 of these persons because of information it had received from the IRS. In the remaining 18 instances, the board had not discovered that these persons had not filed the required tax returns. The board either did not know that these persons had earned sufficient income to require filing a tax return, or the board knew that the persons had not filed the returns but it had not included the commissions when assessing the income taxes owed.

When we applied the results of our sample to the 83,000 commission income reports indicating commissions of at least \$10,000 in 1982, we estimated that 1,500 persons received at least \$10,000 in commissions but may not have filed tax returns. We estimated that these 1,500 persons may each owe the State an average of \$1,920 in taxes and penalties for total estimated tax assessments of \$2.9 million. This amount includes a 25 percent penalty for late filing of tax returns.

The Net Benefit of the Additional
Tax Assessments Would Have Varied
According to Staff Costs and Assignments

The net fiscal benefit the State could have received from the \$2.9 million in additional tax assessments would depend on staff costs and staff assignments. If the board had used existing staff members to audit the cases identified during the computer match, the net benefit

would have been approximately \$2.6 million; if the board had hired additional staff, the net benefit would have been approximately \$2.8 million.

We estimate that the board would have expended 6,100 hours of clerical and audit staff time to produce the \$2.9 million in additional tax assessments. If the board had assigned existing staff members to audit the cases identified by the computer match, the board would have incurred additional clerical costs and would not have obtained the tax benefits derived from other audits that these staff members would have conducted. We estimate that the board would have spent \$14,000 to separate from other information returns the 83,000 commission income reports indicating commissions of at least \$10,000. Furthermore, the board would have spent another \$14,000 to transcribe data from the 83,000 commission income reports onto magnetic tape. The total additional clerical costs, then, would have been \$28,000.

In addition to these costs, staff members would have been removed from audits of tax returns and assigned to audit the cases identified by the computer match. During fiscal year 1982-83, these staff members audited tax returns and assessed taxpayers \$303,000 in additional taxes. The total cost of examining all 83,000 commission income reports (\$28,000) plus the loss of the benefit of other audits performed by the board (\$303,000) would have amounted to \$331,000. Therefore, the net benefit of collecting the \$2.9 million in additional tax assessments for tax year 1982 would have been \$2.6 million.

If the board had hired additional staff to audit the cases identified by the computer match, the board would have increased the net benefit to the State by \$2.8 million. Under this option, the board would have spent \$14,000 separating the 83,000 commission income reports and \$14,000 transcribing data from the reports onto magnetic tape. In addition, the board would have spent \$71,000 in expenses for the new staff members auditing the cases. Thus, the total cost of this option would have been \$99,000.

CONCLUSION

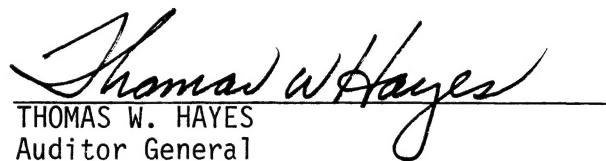
The Franchise Tax Board could have increased tax assessments for tax year 1982 by an estimated \$2.9 million by using data from all commission income reports to identify individuals who did not file required tax returns. The board relied on the Internal Revenue Service to transcribe the data for use by computers; however, the IRS transcribed data from only 52 percent of the commission income reports. The net fiscal benefit to the State resulting from the board's examining commission income reports indicating commissions of at least \$10,000 for tax year 1982 would have been \$2.6 million or \$2.8 million.

RECOMMENDATION

The Franchise Tax Board should expand its activities to identify persons who have not filed the required tax returns. To accomplish this expansion, the board should transcribe onto magnetic tape information from all commission income reports indicating commissions of at least \$10,000. The board should use this information in conjunction with data from the Internal Revenue Service to identify persons who should file state tax returns. Once the board identifies these persons, the board should audit the cases to confirm that the persons owe additional income taxes. The board can implement this recommendation by transferring existing staff members from other activities or by hiring additional staff. By implementing this recommendation, the board will increase its effectiveness in increasing the tax assessments for the State.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,



THOMAS W. HAYES
Auditor General

Date: August 13, 1984

Staff: Thomas A. Britting, Audit Manager
Walt Reno, CPA
Geraldine Parks, CPA
Sara Scully

Memorandum

To : Mr. Thomas W. Hayes
Auditor General
660 J Street, Suite 300
Sacramento, CA 95814

Date : August 6, 1984

File No.:

From : Gerald H. Goldberg

Subject:

We have reviewed the study report, "The State Can Increase Tax Assessments By Identifying Persons Who Earn Commissions But Fail to File Tax Returns," and offer the following concerns and comments:

1. The usefulness of 1099 data is known to us. Cost-effective 1099 data has been used by this department successfully for many years with other data sources to detect nonfilers.
2. The IRS has indicated to us that they plan to transcribe virtually 100% of the 1099 documents, including nonemployee compensation (NEC) cases, for tax year 1984 and all future years. This transcribed data will, as currently planned, be provided annually to this department at a low cost. We believe that the recommended 1099 transcription efforts by us would needlessly duplicate IRS efforts and provide no additional benefit to the state.
3. The 18 potential nonfiler cases were not worked to final conclusion so results were inconclusive. No audits were performed nor were tax returns secured from these individuals to determine what, if any, tax amounts were actually due. Additionally, the estimated tax liabilities of these individuals did not allow for business expenses and itemized deductions which would undoubtedly reduce their net tax liabilities.*

In summary, we are in agreement that 1099/599 data is useful for enforcement purposes, particularly when used in conjunction with IRS efforts. We will continue to utilize this data to maximize our enforcement effectiveness.



Executive Officer

cc: Shirley Chilton, Secretary
State and Consumer Services Agency

*Auditor General's Note: As stated on page 5, we used a method similar to that employed by the board to estimate the amount of taxes that the 18 persons may owe the State.

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps